End the Taxation of Pell Grants and Help Lower-Income Community College Students Access the American Opportunity Tax Credit (AOTC)

Community colleges continue to urge the enactment of two related changes to the IRS Code:

- Make Pell Grants entirely non-taxable to help low- and lower-middle income students retain more of their grant support, thereby reinforcing the program's goals; and,
- Enable community college students to better access the $2,500 American Opportunity Tax Credit (AOTC) by eliminating the Pell Grant offset.

Taxation of Pell Grants

Under current law, Pell Grants are subject to taxation due to their classification as "scholarships" under the IRS code. Students are taxed on any Pell Grant funds used to pay for expenses beyond tuition, fees, and limited required expenses. This tax treatment undermines the Pell Grant program's purpose as a rigorously means-tested benefit that, under the Higher Education Act (HEA), can only be used for education-related expenses.

Taxing Pell Grants has had a harsh financial impact on the lowest-income community college students. Because of low community college tuition, these students are generally the only students in higher education with grants that exceed their tuition, subjecting a portion of the Pell Grant award to income tax. For the 2023-24 award year, the maximum Pell Grant award is $7,395, while the average full-time, full-year community college tuition and fees was just $3,860 for the 2022-23 academic year. On average, then, a community college student receiving the maximum Pell Grant may have more than $3,500 of that award subject to federal tax.

Subjecting any portion of these need-based grants to taxation limits the program's impact and undermines student success. More than two million community college students receive Pell Grants each year, and the program is a lifeblood of student retention, completion, and success. Its tax status must be changed so that students who choose a low-cost college can receive the grant's full benefit, rather than returning some of those needs-based funds to the government.

American Opportunity Tax Credit

The tax treatment of Pell Grants interacts with the eligibility rules for the $2,500 American Opportunity Tax Credit (AOTC) to commonly deny community college students who receive Pell Grants the benefit, even though their need is far greater than millions of other college students who qualify. Under the AOTC eligibility formula, any Pell Grant amount received is subtracted from the tuition and qualified expenses that the AOTC covers. For example, if a low-income community college student pays $4,000 tuition and receives a $4,000 Pell grant, they do not qualify for any AOTC, even though the Pell Grant can cover transportation, living expenses, and other costs that the AOTC does not. In contrast, a student who receives that same $4,000 Pell Grant, and pays the average public four-year in-instate tuition of $10,740, would also receive a maximum $2,500 AOTC, because of their higher tuition. Both students have educational costs that far exceed $4,000, but only the low-income four-year student qualifies for the $2,500 AOTC. At the same time, far more affluent students who do not come close to qualifying for a Pell Grant receive the $2,500 AOTC. Furthermore, there is strong evidence that the complicated tax treatment of Pell Grants results in sub-optimal filings.

Therefore, in making Pell Grants non-taxable, the AOTC statute should be changed to exclude Pell Grants from being counted against a student's eligibility, which is caused by the current tax treatment of Pell Grants. The American Council on Education (ACE) estimates that the change would benefit more than 700,000 financially needy students.

Ending the taxation of Pell Grants and reforming the AOTC to make it work better for low-income community colleges has had longstanding, bipartisan support in Congress. The legislation has also received the support of a broad array of higher education groups.

H.R. 3000, the "Tax Free Pell Grant Act", was reintroduced on a bipartisan basis by Representatives Lloyd Doggett (D-TX) and Mike Kelly (R-PA) in the 118th Congress. A similar version of the "Tax Free Pell Grant Act" was introduced in the Senate by Sheldon Whitehouse (D-RI), in the 117th Congress. Both bills built on bipartisan legislation passed in the 116th Congress, H.R. 3394.

Community colleges seek enactment of legislation drawn along the lines of The Tax-Free Pell Grant. All legislators should support this common-sense, low-cost legislation that will improve existing higher education assistance programs to better reach the students who need the most support.

For more information, please contact AACC Senior Vice President of Government Relations David Baime (dbaime@aacc.nche.edu).